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NO. 81-523

In The

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeals
of the State of California
for the First Appellate District

BRIEF OF THE STATE OF MONTANA AS AMICUS CURIAE IN SUPPORT OF APPELLEE

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United States Supreme Court Rule 36 1

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I.

INTRODUCTORY STATEMENT

Pursuant to United States Supreme Court Rule 36, the State of Montana submits this Brief as an *Amicus Curiae* in support of the Appellee. Both parties to this proceeding have consented to the filing of this Brief.[1]

[1]Originals of the "blanket" consent letters of both parties have been filed with the Clerk of the Court.

II.

INTEREST OF AMICUS CURIAE

The interest of the State of Montana as an Amicus in this matter revolves around the potentially far reaching effects of this Court's final decision as it relates to the ability of a state to tax multi-jurisdictional businesses. The State of Montana is concerned with the Appellant's position that the application of combined apportionment to a corporation and its foreign subsidiaries on a worldwide basis constitutes a violation of the due process and commerce clauses of the United States Constitution.

It is essential that this Court affirm the decision of the California Court of Appeals in *Container Corp v. Franchise Tax Bd.*, 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981). A decision from this Court reversing the California Court of Appeals will effectively erode several years of effort in producing relative uniformity among the states in the area of state income taxation, as well as seriously subvert the ability of the State of Montana to tax rationally the multi-jurisdictional taxpayers operating in this State.

Another ramification of such a reversing decision would be the further erosion of the Montana tax base at a time when state and local governments can ill afford the revenue loss. A multi-jurisdictional business enterprise must be subject to a state taxing authority in the same capacity as a smaller, completely localized enterprise. Any method to the contrary would create the inherently unfair result of smaller enterprise shouldering the state and local tax burden of the multinational business entity.

———o———

III.

SUMMARY OF ARGUMENT

This Brief will focus on an examination of the auditing problems posed by a multi-jurisdictional corporation to both federal and state governments as well as the respective approaches taken in determining and ultimately taxing the income of such taxpayers. This *amicus* submits that the approach taken by the states in utilizing the unitary business principle not only meets basic constitutional standards but also possesses clear advantages to the separate-entity "arms-length" approach of the Federal Government in attributing multinational corporate income for tax purposes.

IV.

ARGUMENT

A. Multinational businesses give rise to unique audit problems.

> In this age of the supercompany with its sophisticated pattern of world-wide operations and financial dealing, there is perhaps no more difficult problem for the tax administrator than the examination of the tax returns of multinational corporations.[2]

Since the end of World War II, there has been an explosion in the size of the international business community.

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[2]Donald Alexander, Commissioner of Internal Revenue, "Auditing Multinational Corporations," Address to the Assembly of Inter-American Center of Tax Administration, Ottawa, June 13, 1975.

Companies which once restricted their activities to a single country are now involved in the domestic economies of a number of countries. Business opportunities now exist on a global scale and the modern business enterprise tailors its operations to exploit the advantages offered by a variety of circumstances. As a result of this growth of business, the problems of the tax administrator have become ever more complex and exasperating. Not only are global market forces at work in shaping business decisions, but also the presence of a business in numerous jurisdictions allows significant opportunities for corporate planning to take advantage of tax opportunities or shields offered by a variety of countries.

Multinational businesses almost invariably operate through a number of legally separate entities. This does not mean that they operate as separate businesses however. In almost all cases they function as a single business. Shareholders in major corporations are concerned with bottom line results, not where income is earned. Corporate managers function in a way which satisfies stockholder expectations or they look for new jobs.

The nature of multinational businesses gives rise to unique problems for the tax administrator because they are unrestrained by the economics of a single country in making business decisions and in particular in transferring goods between related entities. Transfer prices may be relevant to a local manager if his performance is judged solely by the results he obtains in his segment of the business, but they are irrelevant to the business as a whole. The only relevant figure for the business is the difference between the cost of an item and the amount realized when

it is sold to a third party. As a consequence, transfer pricing can be utilized to influence tax results. This may not be the only reason for establishing particular transfer prices, but the fact that beneficial tax results can be achieved through appropriate pricing strategies cannot be ignored.

A multinational business may give rise to economies of scale which generate large amounts of income. This can occur whenever there is a decreasing marginal cost of production. Decreased costs may make sales profitable at a price level below those justified by the exploitation of a single market. Does the additional sale give rise to the increased profit or is the profit the result of all sales?

Beyond the direct results evident from the lowering of per-unit costs, there can also exist a number of synergistic benefits which are even more elusive of measurement. Economic benefits can arise from size alone in terms of borrowing capacities, credit requirements, supplier preference, etc. Sometimes these benefits are measurable; at other times they are intangible. In any event, they cannot be specifically identified with one activity. The synergism results from the interaction of all of the elements of the business, or at times from the existence of all of the elements as a part of the whole. In such a case the income which results should be divided among each of the constituents. It cannot be assigned to any one or several of them.

An example of a real but intangible benefit unidentifiable by source was discussed in *Butler Brothers v. McColgan*, 315 U.S. 501 (1941). In that case, the Court considered the effect of volume discounts and the stipulated fact that the elimination of California purchases would

have no effect on the amount of the discount. The Court responded in the following manner:

> . . . If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting from the purchasing of goods in large quantities. . . .

315 U. S. at 508-09.

B. The approach of the federal government to the problem.

The Internal Revenue Code operates on the basic premise that residents of the United States, individual or corporate, are taxable on all of their income. Credits are allowed to the extent foreign jurisdictions assert tax over a portion of a resident's income because it has a source in the foreign jurisdiction. In some instances, a deferral is granted for United States taxation until the income is repatriated. Allowing credits or classifying income as being "non source" are the exception rather than the rule.

As an aid in administering the system, § 482 of the Internal Revenue Code (26 U. S. C. § 482) provides the Internal Revenue Service with policing power. It provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, owned, or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, cred-

> its, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The Department of Treasury has adopted implementing regulations (Treas. Reg. § 1.482-1, *et seq.*). The regulations establish three specific methods and a fourth general method for adjusting intercorporate transactions on the basis of the arm's-length standard (Treas. Reg. § 1.482-2 (e).) Under the regulations, transactions between commonly controlled entities are reviewed and compared to hypothetical comparable transactions between unrelated entities. The regulations establish a hierachy of comparisons: the comparable uncontrolled price, the resale price, cost plus, and any other method that is clearly more appropriate.

The regulations attempt to compare intercorporate transactions to those conducted by separate entities. It views each corporation as separate and independent and uninfluenced by the existence or opportunities to deal with related entities.

> . . . Since each commonly-controlled entity is viewed as separate and independent, the government will calculate its true taxable income by adjusting intercompany transactions to conform to the results of bargains which would have been negotiated between unrelated parties dealing at arm's length in similar goods or services in similar circumstances. Moreover, each entity's profit or loss on any intercompany transaction does not depend on whether the MNC [Multinational Corporation] as a whole has yet made or ever will make any real profit through ultimate resale to

third parties of the goods or services. (89 Harv. L. Rev., *infra*, 1202 at 1205.)

C. Criticism of the Federal Approach.

The separate entity approach followed by the Federal Government has been subject to substantial criticism. This criticism has come from legal scholars Geoffry John Harley, "International Division of the Income Tax Base of Multinational Enterprise", 89 Harv. L. Rev. 1202 (1976), the Treasury itself (The President's 1978 Tax Program, January 30, 1978, pp. 282-297), and the General Accounting Office ("IRS Could Better Protect U. S. Tax Interests in Determining the Income of Multinational Corporations," September 30, 1981) among others.

As the following extracts demonstrate, the federal approach is theoretically inappropriate because the separate entity approach does not conform with economic reality. Commonly controlled corporations are aware that additional benefits to the business as a whole may be derived from dealing with one another; therefore, they do so.

> Whenever commonly-controlled entities directly contribute, either horizontally or vertically, to a single production-distribution process, opportunities for cost savings through economies of scale and reduced transaction costs may result. Even where no direct transfers are made, centralized managerial control over a group of affiliates may produce efficiencies in management, in raising capital, in obtaining quantity discounts, and in advertising. In addition, diversification of risk creates potential savings where there are few similarities between affiliates.
>
> Finally, political and economic power, which may be used to increase long-run profits of the whole MNC, may stem from large size alone regardless of the de-

gree of compatibility between the affiliates. As a result of all of these considerations, transfer prices may vary from arm's langth to reflect the increased profitability of intercompany transactions.

89 Harv. L. Rev., *supra,* 1202 at 1215.

Some [corporate] officials believed the fundamental concept of arm's length dealing between related corporations is unrealistic. In a world of competition among multinational firms, they ask why the parent corporation should not favor its subsidiaries over unaffiliated corporations. The subsidiaries are expected to pay dividends while the unaffiliated corporations are not.

GAO, *supra,* at p. 44.

Section 482 is based on the premise that a subsidiary is legally and economically separate from its parent corporation. In contrast, only 41% of the participants state their organizations actually operate in this manner. Although composed of numerous legally separate entities, 49% of the participants reveal that their companies make most intercompany pricing decisions as though the organization *is one economic unit.* This basic difference in philosophy between the IRS and multinational corporations is central to the Section 482 controversy. Without this fundamental difference, many tax problems involving intercompany transfer pricing would disappear.

Burns, "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey", *The Journal of Taxation,* (May, 1980), p. 308.

Such an approach may give rise to artificially created records and may eliminate the use of one of management's tools for evaluating employees or rewarding performance.

. . . The government's insistence on the separate entity theory for tax purposes may result in the adop-

> tion by MNC's of arm's length pricing rather than an administered transfer pricing system more appropriate for internal control and motivational purposes. Such a system, which is designed to reflect the fact that an affiliate may have contributed to long-run MNC profits despite its failure to produce short-run profits measured in terms of arm's length prices, is crucial to the promotion of full cooperation by all affiliates in achieving the MNC's world-wide goals, even when it is not in their individual interest as profit maximizers.
>
> 89 Harv. L. Rev., *supra,* 1202 at 1217.

In addition, the separate entity approach may give rise to significant administrative costs and burdens.

> Some [corporate] officials drew attention to the expense and labor involved in international examinations. The officials objected to what they considered an unnecessary load of paperwork. For example, the tax manager of one company declined to guess the cost of satisfying IRS examiners that international transactions do not violate section 482 regulations, although he believed the costs to be considerable. He said that he did not object because he considers the defense against IRS allocations a necessary function of his tax department. He did state, however, that the examiners raise many questions that take time and trouble to answer without being closely related to the examination.
>
> GAO, *supra,* at 44.

Finally, the separate entity approach as represented by the arm's-length standard does not work,

> . . . The arm's-length standard is a necessary and valuable tax measure, but it is sometimes difficult to administer: multinational firms often invest abroad because no well-established market exists for the goods and services which are transferred in inter-affiliate transactions. . . . Although many multinational com-

> panies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U. S. tax revenues can be substantial.
>
> Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. But no one familiar with international tax planning believes that these Regulations have taken the tax incentive out of transfer-pricing. The 1968 Regulations reduced, but by no means eliminated, the flexibility which companies have in setting inter-affiliate prices.
>
> President's Tax Program, *supra,* pp. 286-287.

and constitutes an administrative and taxpayer nightmare,

> In its review of current IRS examination data on 519 U. S. multinationals, each having assets over $250 million and having engaged in transactions with its foreign subsidiaries, GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income were based on a true arm's length price. The remaining adjustments were based on estimated prices constructed by IRS using complex guidelines prescribed by the department of the Treasury-guidelines which have caused administrative burden and uncertainty both for IRS and taxpayers.
>
> GAO, *supra.*

D. The States' approach.

The States, in applying their corporate income taxes, are limited to source income by due process considerations. *Wisconsin v. J. C. Penney Co.,* 311 U. S. 435 (1940); *Complete Auto Transit Inc. v. Brady,* 430 U. S. 274 (1977).

In order to make source determination, the States have adopted the unitary business principle. Under this approach, the States first determine the nature of the business undertaken in their state and then include all the income, wherever and by whomever earned, of that business in an apportionment base. This base is then assigned to the various jurisdictions where the business is taxable upon the basis of a mathematical formula reflecting business activities. The formula typically includes property, payroll and sales.

The unitary business principle is unconcerned with where income is assigned on the corporate books or records. It assumes that all elements of a business contribute to the earning of income. If the business does not earn income on an overall basis, then there is no income to assign anywhere.

1. Criticism of the States' approach.

The unitary approach is criticized on the grounds that the elements of the apportionment formula (property, payroll and sales) are not equally productive of income in every jurisdiction.

Second, it is asserted the perimeters of a unitary business are difficult to define and frequently shift solely on the basis of the amount of taxes which accrue to a state based upon a particular configuration.

Third, it is alleged that compliance costs under the unitary method are excessively burdensome because taxpayers do not maintain adequate records to calculate property, payroll and sales on a uniform basis.

Finally, it is claimed that the use of the unitary method may give rise to multiple taxation in the inter-

national context where foreign countries utilize the arm's-length method.

2. Response to criticisms of the States' approach.

Criticism of the formula elements misses the point of the unitary business principle. The unitary method is utilized because the income is part of an inseparable whole. As the Court stated in *Underwood Typewriter v. Chamberlain,* 254 U.S. 113 (1920):

> . . . The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut, and ending with sale in other states. In this it was typical of a large part of the manufacturing business conducted in the state. The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It therefore adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach only the profits earned within the state. . . .
>
> 254 U.S. at 120-21.

Furthermore, the elements of the formula frequently offset each other. When property costs are high, payroll costs may be low. Sales may offset both. In order to overcome the presumption attached to the formula, the taxpayer must demonstrate how all the elements together have unfairly apportioned income. It should also be kept in mind that mathematical precision is unnecessary. A rough approximation is sufficient. *International Harvester Co. v. Evatt,* 329 U.S. 416 (1947).

In the instant case, the perimeters of the unitary business are defined on a line-of-business approach. This

meets the requirements of the Multistate Tax Commission Regulation Reg. IV.(1).(b), and is in conformity with the suggestions of commentators. (*See,* 89 Harv. L. Rev., *supra,* at 1235.) This Court should not speculate on the effects of the use of the unitary method in cases not before it.

The compliance cost arguments are raised with respect to either the arm's-length method or the single entity approach. The unitary method, by ignoring individual transactions, should be less burdensome in any event. The existence of additional costs in the instant case are virtually precluded by the Securities and Exchange Commission filing requirements with respect to its Form 10-K.

The use of an apportionment approach precludes multiple taxation. "Logically it is impossible, when the tax is fairly apportioned, to have the same income taxed twice." *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 462 (1959).

3. Comparison of the Federal and State approach.

The unitary entity theory has certain clear advantages over the separate entity approach now embodied in the section 482 regulations. Principal among these is its theoretical superiority as a means for ascertaining true income of various MNC components. Treatment of the MNC as a unitary entity reflects the fact that strong interdependence from common control may exist which renders unrealistic any analogy to a collection of unrelated, competitive companies. Furthermore, the unitary entity theory does not create taxable income on the basis of intercompany transfers, since such transfers do not make the MNC as a whole better off until income is realized

> from ultimate sales to unrelated parties. Finally, a unitary formula provides management with the flexibility necessary to make efficient use of transfer pricing for internal and external non-income tax purposes, thus avoiding the frustration of legitimate business behavior which may accompany application of the separate entity theory.
>
> 89 Harv. L. Rev., *supra,* 1202 at 1228.

The GAO in its report, *supra,* recommended that the Department of Treasury:

> Begin a study to identify and evaluate the feasibility of ways to allocate income under section 482, *including formula apportionment,* which would lessen the present uncertainty and administrative burden created by the existing regulations. (Emphasis added.)
>
> GAO, *supra,* at pp. viii-ix.

———o———

V.

CONCLUSION

It is respectfully requested that this Court sustain the unitary business principle and affirm its application by California in this case.

Respectfully submitted,

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